DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 1759
La Jolla, Calif. 92038

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Aug 1, DJIA 826.50; PTI 371; A-D ratio -27.81
Aug 8, DJIA 817.74; PTI 349; A-D ratio -29.03

Broker: Charlie, I'm calling because I've got some good news and some bad. Charlie: OK, I'm sitting down, so hit me with the bad news first. Broker: Well, the Freakington International stock we bought a few months ago at 90. It sold down to 3 yesterday. I'm sorry, Charlie, it came right out of research, but it's just one, uh.... Charlie: I'm feeling a little dizzy, but what's the good news? Broker: The good news, Charlie, is that Freakington's entire decline has been on very low volume!

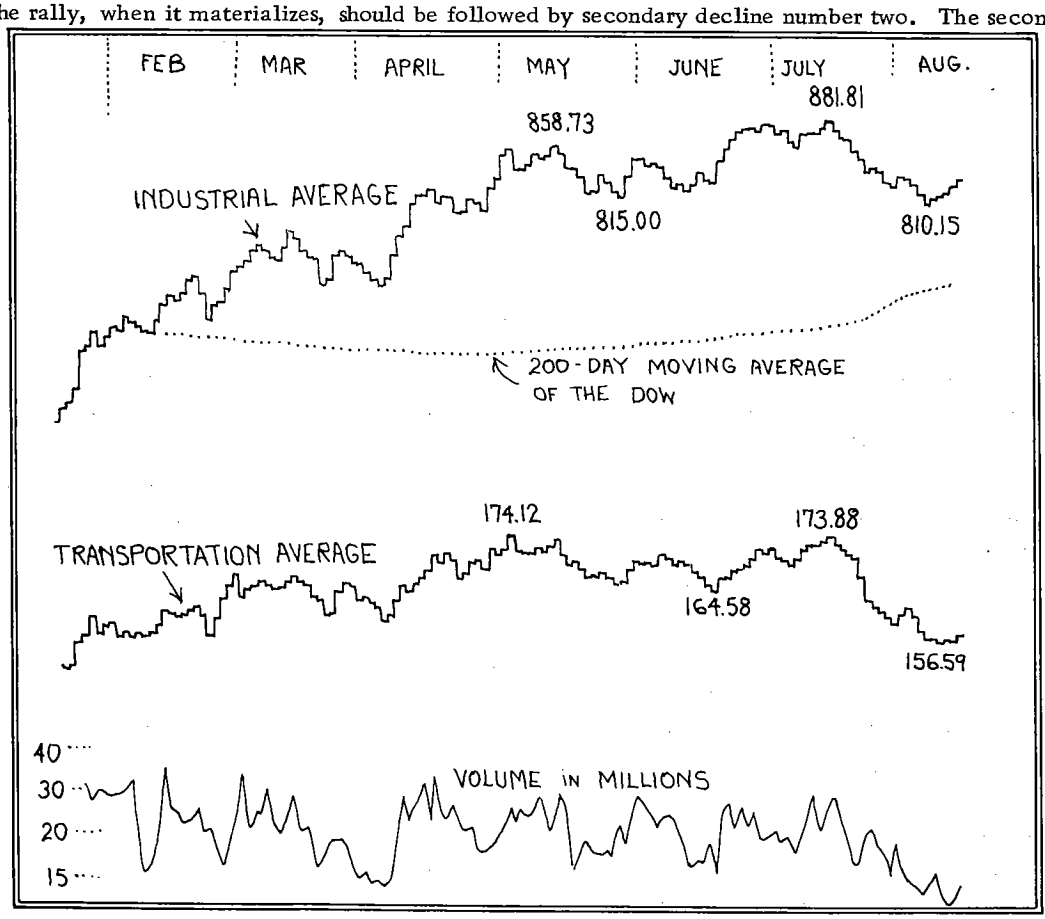
THE PICTURE: 1973-74: The windup of years of deteriorating market breadth, non-confirmations in the Averages, mounting economic problems for the US. The stock market collapses to new lows, the Dow Industrials to 577.60, and most stocks to extraordinary lows not seen in years. To all appearances, a major bear market bottom has arrived in late-1974.

1975: Bouncing off its October-December bottom, the market plows ahead during the first half of 1975. By July the Dow has recovered more than half of the losses suffered during 1973-74. Bullishness returns to Wall Street, and by all accounts a new primary bull market has started.

July 15, 1975: The market and many indicators record 1975 highs. Then, in the space of three weeks, the Dow breaks from its 1975 high of 881.81 to an August 5 low of 810.15. The decline occurs on very low volume, locking in large quantities of stock which came in during the heavy volume June-July rise. On August 11 the Transports break to 156.59, lowest level since mid-February.

The question: What does it all mean, what's happening, what could occur in the period ahead? First, we now have a market that has formed a top in mid-July. Personally, I have never liked July tops, and I explained why in the last report. Further, I reviewed the history of the market in which July tops had formed. In the great majority of cases, the declines extended into the October-December period, producing a "buy spot" towards the end of the year.

It does not always happen this way, but most secondary reactions develop in the form of two well defined declines separated by a recognizable and often substantial rally. My guess is that we are now seeing the first "downer" in this correction, and we are probably nearing the rallying stage. The rally, when it materializes, should be followed by secondary decline number two. The second decline should be steeper, longer, and in general scarier than the first.



"Scarier in what way?" you ask. There are two phenomena that serve to frighten stockholders: (1) prices going below where they were "expected" to go on a reaction, and (2) prices going down on heavy or panic-scale volume. Both of these phenomena could occur during the current secondary correction. If so, they should make their appearances around late-September or October. And if they do materialize, I would hope that no readers of these reports will be shocked, surprised or caught with their stock certificates in their shaking hands.

Why has the market sold off? Technically, a secondary correction acts as an escape valve for Wall Street. A secondary lets out some of the pent-up pressure, and it dampens some of the excitement brought on by those early, "easy"

profits. By the time a secondary is over, many of the paper profits have turned to losses, and some of the late-comers' mild losses have turned into massive losses. That's the way secondaries work.

Some secondary reactions are purely technical and psychological in nature. They have little to do with forthcoming economic trends. The 1962 slide was a good example of this kind of correction. Other secondaries serve to warn of coming economic contractions. Examples of these are the declines of 1953, 1957 and 1960.

At present, we have the market backing off in the face of one of the most difficult periods in American economic history. Last week the Government announced that July wholesale prices jumped at an annualized 14% rate. This occurred amid a period of high unemployment, declining loan demand and inventory liquidation. It occurred with the nation at or just off a recession bottom. The spector of double-digit inflation arising even while the national is in recession presents a situation beyond the experience of anyone in or out of Government today.

Only a few weeks ago Federal Reserve Board Chairman took issue with Agriculture Secretary Butz regarding the effects of Soviet grain buying from the US. The Soviet purchases will be inflationary, said Burns, they will drive food prices up. When the Fed Chairman is willing to take public issue with an Administration official on the matter of inflation, we might as well realize that he is not mincing words. He is issuing a warning, and he is telling us where he stands on the matter of inflation.

In view of this, my own feeling is that Mr. Burns and the Fed will now seek the middle course in monetary affairs. If that does not work they will move towards monetary restraint. Mr. Burns, despite the coming 1976 election, does not appear ready to compromise on inflation.

It is a safe guess that the market knows this. The bond markets, sensing restraint and higher yields, have been coming down. The stock market has also been taking the down-escalator. And an air of foreboding has come over Wall Street as exchange volume has suddenly contracted. Like an animal caught in a trap just as the heavy door is about to slam shut, a stillness has come over Wall Street.

One thing I have been pondering about is the whole issue of inflation and where it stands from a contrary opinion stance. Here is the way I think. Market analysts and economists argue about a great many things these days, but one area they agree on almost to a man is inflation. More inflation during 1975 and 1976, we are told, is "in the bag." Personally, I see the possibility of a cross-up in this area.

(1) The stock market has turned nasty, and it wouldn't surprise me to see the current correction ultimately carry considerably further than expected — perhaps below 700 on the Dow. The market (and particularly the collapsing Transports) seem to be telling us that business isn't going to perform as expected. In fact, I would say that the market is moving down to safe level in anticipation of a good many business disappointments this fall.

(3) Despite the upside pop in silver, gold is acting poorly, and it has not been able to get back above the 170 level. Gold acts almost as if it is beckoning the suckers to come in. It's hard for me to believe that the big inflation is just around the corner while bullion is acting like a wet rag. If gold breaks down to the 160 level, it will be an indication that the inflation story may not materialize this fall and winter. Yes, I know that gold has been moving up against the other currencies (rather than against the stronger dollar), but the dollar is now overdue to a correction, so let's watch the dollar price of gold.

(4) The bond market had a big 1975 rally, and it has now turned weak. Yet all the weakness in the bond market is based on improving business and rising interest rates. The bond market could be wrong about the business picture. If it is, if business turns sloppy, we'll see a big bond rally. I don't see both stock and bonds going down from here. They're going to part company soon, and my bet is that bonds will hold while stocks (following this rally) continue down.

(5) The negative volume index (shown in the last Letter) has been dropping to drastic new lows. This means that as volume contracts, stocks, instead of holding, have been caving in. That's not good action, and I'll go further and say it's downright ominous. I don't think it's saying "inflation," but again time will tell.

NEAR-TERM: (see chart page 1).... On August 5 the Industrial Average recorded a reaction low of 810.15. Four trading days later, on August 11, the Transports sank to a reaction low of 156.59. The minor new low in the Transports was not confirmed by a corresponding new low in the Dow. This little non-confirmation, fortified by a heavily oversold condition in the general market, set the stage for a rally.

The odds favor a second leg for the reaction, a downward swing which could easily test the Dow's 200-day moving average (which now stands at 742). As far as the upside is concerned, I feel that there is a better than 50/50 chance that the highs for 1975 were seen at the July peaks. From the standpoint of the market's health, it would be preferable at this juncture to have a full-fledged reaction rather than a half-hearted and labored attempt on the part of the Averages to push above the July highs.

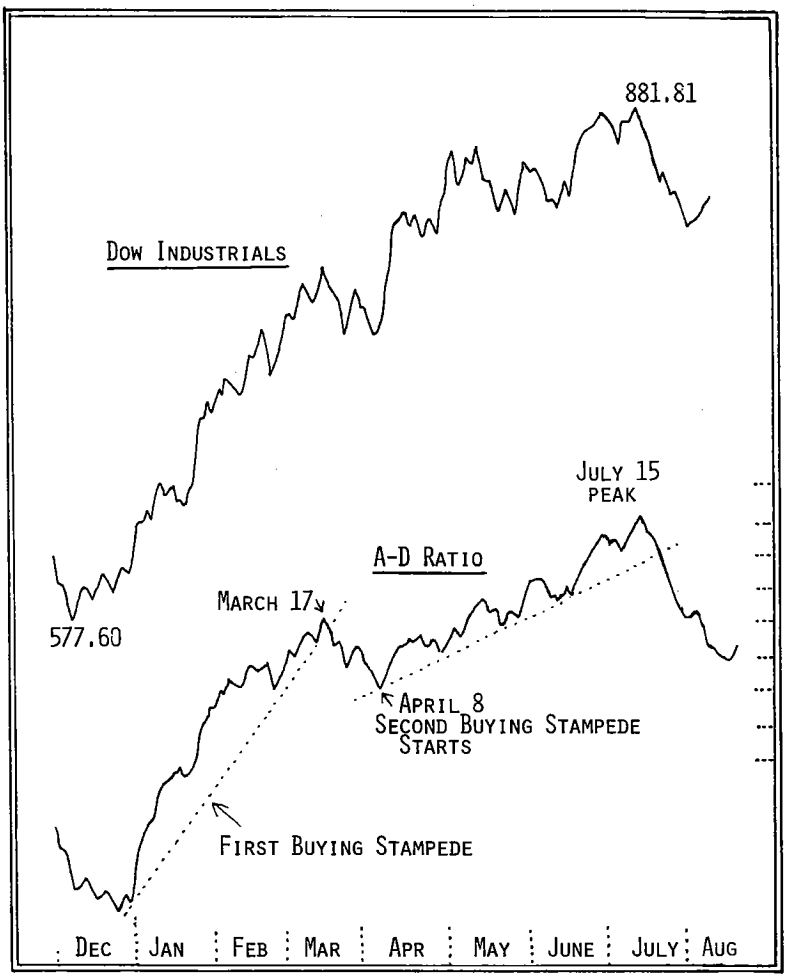
Referring to the chart of the A-D ratio, note that the damage which has been administered to the breadth has been drastic. In the space of a month, all the gains in the A-D ratio since mid-February have been erased. This raises the question of what will happen if the Dow now stages one of its famous solo advances. A big upside bounce in the Dow could place the market on even more tenuous footing that is now the case. The reason is that the stage is now set for divergence on the upside if the A-D acts sluggish or resistent as the Dow rallies. But this is getting ahead of the game, and for now it is sufficient to note that the market is in technical trouble.

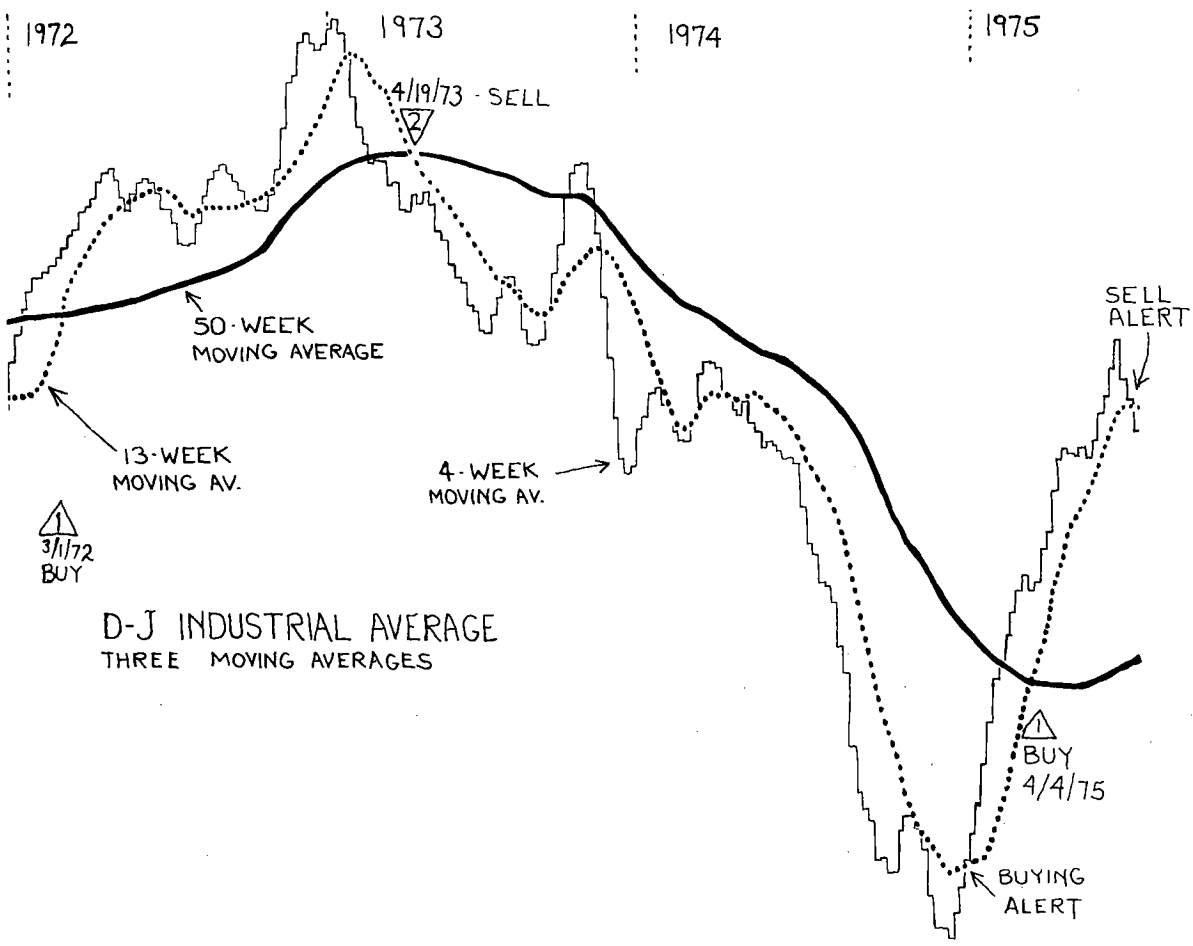
NOTE: As I was writing the above, I received a letter from my old friend, A. M. Shumate, a veteran Dow Theorist (co-author of "The Dow Theory Explained") and an observer of Wall Street since the 1930's. Shumate writes (Aug. 6), "Well, finally, the Industrials yesterday confirmed the downward secondary by crossing the 815.00 level of 5-29-75. I expect the closing of the gap of some 7 points left between Friday and Monday January 24-27, specifically to the intra-day high of 1-24-75 at 671.46. This would be a shade more than a 2/3 retracement.

"I am sorry to say that I expect a very irregular decline, taking up considerable time, and making the shorts quite uncomfortable. Shorts, however, and more shorts, are just what this market needs in the months ahead."

MOVING AVERAGES: Veteran readers of these reports are familiar with my studies of the three moving averages of the Dow. I use a short-term or 4-week MA, an intermediate-term or 13-week MA and a long-term or 50-week MA. The major signals are given when the 13-week MA crosses above or below the 50-week MA. Referring to the chart, note that a buy signal was set off on March 1, 1972 when the 13-week MA moved above the 50-week MA.

The market pushed up throughout 1972, topping early in 1973. On April 19 the MA's gave a sell signal, and those who took that sell signal seriously avoided the worst stock market collapse since the 1930's. Following a pointage huge spread between the 13 and 50 week MA's during late





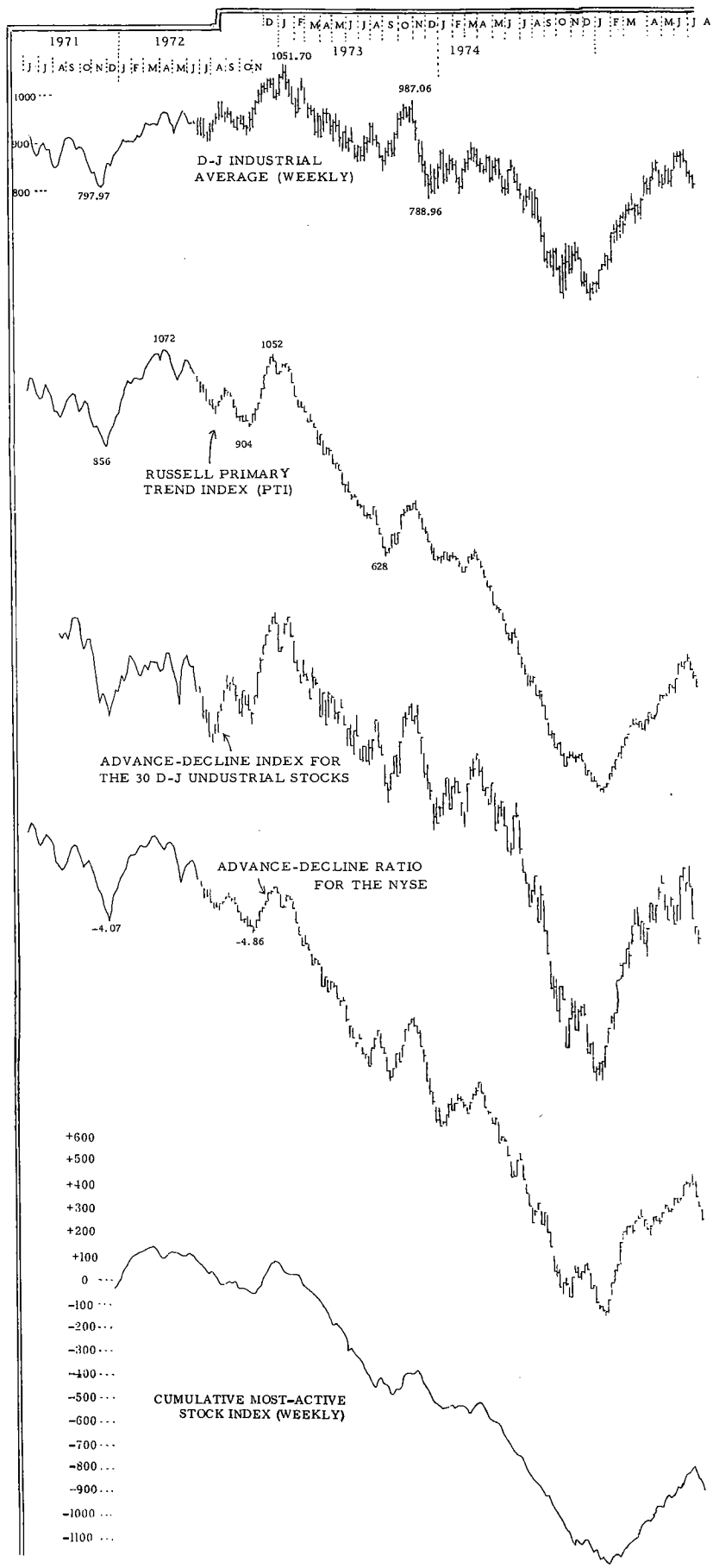
1974, a buy signal was given on April 4, 1975. So far, that buy signal is still in effect, and from a long-term standpoint, the MA's are still in a primary bullish position.

But again I will say to subscribers that no mechanical technical system is going to put you on the road to riches in the stock market. I don't care what system you use, you're going to have to think, interpret, analyze, use your head. For instance, market movements during recent years have increasingly resembled straight-line advances or declines. In other words, the market turns up and just keeps going, or it turns down and never stops dropping. All of which creates a problem for the man who likes to take his time and make his move following a period of calm and thoughtful deliberation. For instance, the investor who took his time before selling during 1973-74 ended up broke. By the same token, the man who mulled the whole scene over carefully during early 1975 ended up missing the rise or buying too late.

I stated that major signals are given when the 13-week MA moves above or below the 50-week MA. A buying or selling alert is provided when the 4-week MA rises above or falls below the 13-week MA. Of course, the alerts occur much more often than the major signals, and thus they are much more prone to whip-sawing those who act on every buying or selling alert crossing.

Note the buying alert of January, 1975, created when the 4-week MA pushed above the 13-week MA. I took that as a buy signal, since it came following a two-year collapse in which the 13 and 50 week MA's had spread apart by an incredible distance of 133 points. Now look at the recent 1975 high. At the highs, the 13 and 50 week MA's had spread apart by a whopping 120 points. The market was becoming highly over-bought, and the rise had gone a long, long way towards discounting better times. Last week (week ending August 8) the MA's gave their first selling alert, brought on when the 4-week MA plunged below the 13-week MA. I feel that the August 8 selling alert could be a good one, and I think it's important enough to act on. The 13 and 50-week MA's are still 113 points apart, and at a weekly closure rate of 10 points, it would take three months for them to cross. Considering the straight-line character of the advance since late 1974, I would say that discretion is now the better part of valor. Why be greedy, why be a gambler? I would rather be out now, and perhaps pick up stocks again at what looks like a fall bottom. I believe the MA studies are telling us something. And my intuition tells me that the sell alert should be heeded at this time.

PERSPECTIVE: I include on this page my weekly (high-low and closing) chart of the Dow Industrial Average plus four leading indicators which I follow. The period covered is 1971 to date. One thing that



immediately catches our eye is the fact that although the Dow recovered 64% of its 1973-74 losses during the big 1975 advance, the other indicators failed by a wide margin to duplicate this feat.

For instance, during 1975 the Primary Trend Index (PTI) pushed up to its March, 1974 level, but at the 1975 highs the PTI was still far below its 1973 peak of 1052. The PTI (my own indicator) is an amalgam of eight critical indices including the three D-J stock Averages, the D-J Bond Average, the S & P 500 stock Average, the daily advance-decline ratio, the daily high-low figures, and the daily most-active stock index. As stated in the last Letter, the PTI marched relentlessly higher from December, 1974 to July 15, 1975, while gaining a total of 298 points (the PTI lost 927 points during 1974). Whether the PTI will be able to better its July 15 peak of 423 remains to be seen.

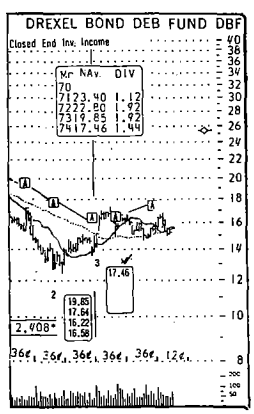
The second indicator is the advance-decline index for the 30-Dow Industrials. This is an index I keep (I don't think any other advisory keeps it), and it provides a continuing test of the breadth of the Dow. The Dow A-D gained 454 points during late-1974 to the July 15 peak, and since mid-July the Dow A-D has given up a total of 163 points or one-third of its gains. Here again, we have an upside market point of 454, and a continuing bull market will have to take the Dow A-D above that level.

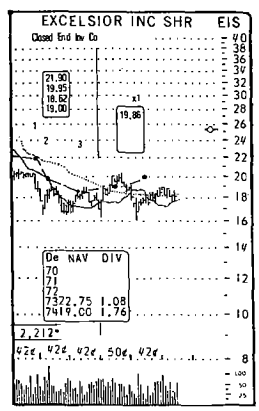
One of the worst drubbings was taken by the A-D ratio, the index which traces the advances and declines of all stocks on the NYSE. Here we see the two separate buying stampedes which have characterized the bull market so far. The July-August sell-off has already served to wipe out a fair portion of all 1975's gains. Theoretically, the man who bought in December and sold out in mid-March would now be ahead of the game. Many of my subscribers did just that.

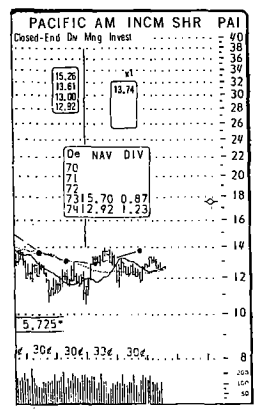
The last index on the chart has acted as the powerhouse of this bull market, and this is the cumulative most-active stock index (CMAS). The CMAS is simply an advance-decline index based on the daily plurality of the 15 most-active stocks on the NYSE. CMAS pushed up like a tiger all through 1975, and right up to its peak of July 15. The low for CMAS was reached on December 23, 1974, at minus 1216. CMAS then pushed steadily up to a July 15 top of minus 785, a remarkable 140-day gain of 431 points (or an average daily plurality gain of 3 per day). In other words, for 140 days there was an average gain on the most-active list of three more up stocks than down stocks. That is real power, and it may be a long time before we see its equal again.

Conclusion: We have a number of upside marker points (peaks) at the 1975 highs. It will be important and instructive to note whether ultimate renewed strength in the market will be able to take the various indices above the July peaks.

STOCKS: Charles Dow in all his writing gave primary emphasis to values. Anyone who has spent any considerable time investing in stocks will probably agree that stock values cannot be overemphasized. The yield on the Dow Industrial Average is now 4.75%, the yield on the broad S & P 500 Stock Index is 4.30, the yield on Moody's Aaa (highest-rated) bonds is currently 8.93%. All of which means that stock yields (dividends) will have to double before they reach the yield basis now provided by the highest rated bonds.







I have mentioned some of the closed-end bond funds in previous reports, and I want to discuss them again now. A number of these funds are traded on the NYSE, most are now selling under net asset value, and despite all arguments to the contrary, I consider these funds to be outstanding values.

The bond funds are traded exactly like other stocks on the NYSE. Unlike a mutual fund, when you purchase a closed-end fund you are simply buying shares in that fund from another investor (in the same way you buy GM from another investor). The reason I want to mention the bond funds again is that a number of these funds are not only selling below net asset value but they are yielding 9% to 10% on their dividends (all their income comes from interest or trading profits from their diversified bond holdings).

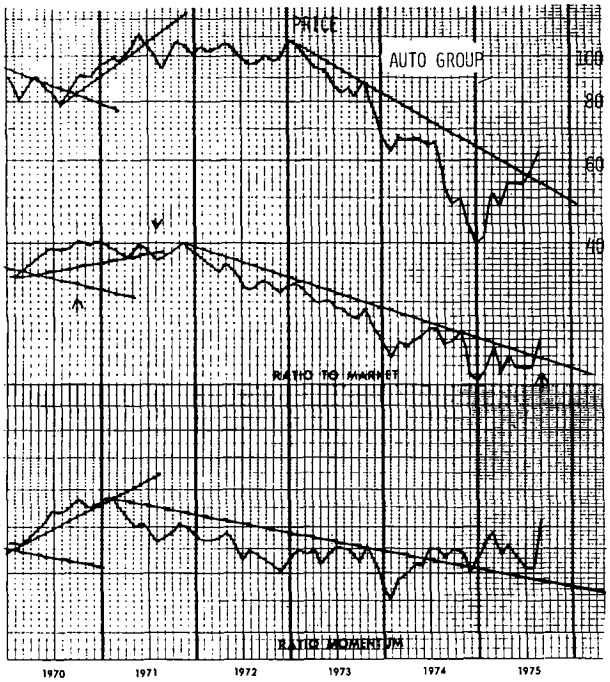
At 10% compounded annually (not monthly or quarterly, but annually!) money doubles every seven years. And that's a major reason why the bond funds (despite any and all fluctuations based on changing interest rates) are a most interesting investment at this time. The Drexel Bond Debenture Fund is now selling at 12% below net assets, Pacific American Income Shares are selling at 9% under net assets, and Excelsior Income Shares are selling at 9% under net assets. All three are yielding between 9% and 10% at current prices (charts courtesy of Quote, PO Box 213, Wichita, KS 67201).

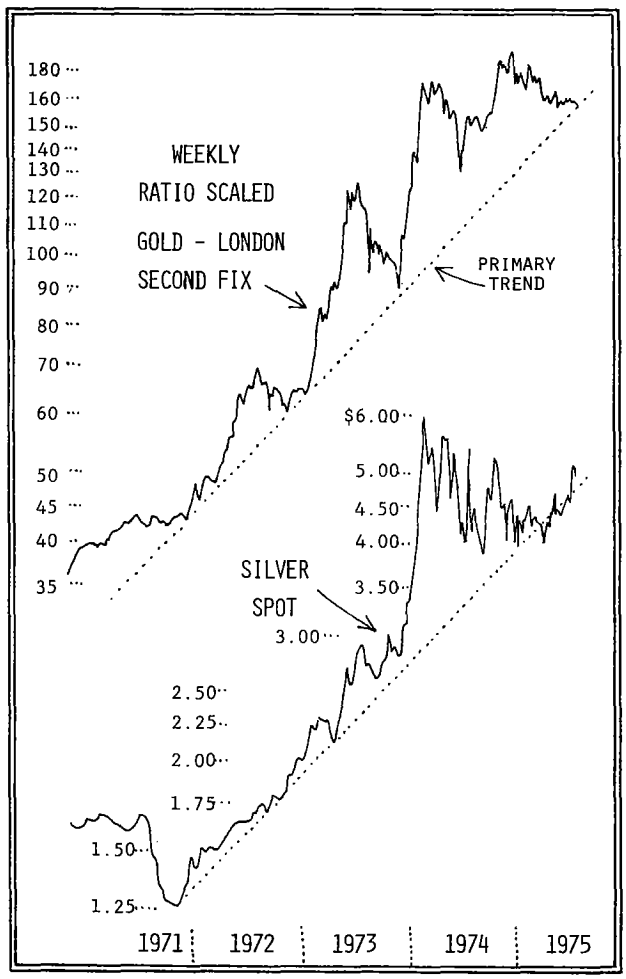
I would recommend a package of all three of these bond funds to subscribers simply as a high-yield long-term holding. My reasoning is this: The bond funds at 9-10% yield are values. If bond yields don't ultimately come down, then this economy will not survive. I am beginning seriously to doubt the widely-held thesis of "coming hyper-inflation." I believe that on any real sign of hyper-inflation interest rates will immediately jump. This will knock down stock prices and business together.

Therefore, it is very probably that we have seen the lows for the stock market (in 1974), but that we are also locked into a trading range with interest rates ready to pop on any sign of runaway inflation. At the same time a business collapse will be held off by rising corporate liquidity and increasing conservatism on the part of our leaders. It appears to me that Mr. Ford is in for another four

years, and this is a plus for the forces of anti-inflation. Under these conditions, a broad market trading range is what we might expect.

Most people cannot consistently make 10% a year trading the market (believe it or not). You can make a quaranteed 10% by holding the bond funds. That's why I like them here. They should be excellent vehicles for the period ahead. I believe that we could be in for a series of mini-bull and bear markets, all occurring within the 1050-577 Dow limits, (much like those of the 1939-49 period). If so, there are going to be a lot of frustrated Wall Street geniuses. But income is income, and that's what true investing is all about.





One of the more interesting facets of today's market is the August breakout in relative strength for the Auto group. Yes, it's happened, the motors are now acting better than the market for the first time in four years. This could mean better times for the Auto stocks or it could mean that they have dropped so low they are being accumulated as undervalued situations. At any rate, the outstanding performance in the group is being turned in by GM, and this is not bearish for the market in general (I am not a great believer in the thesis that as GM goes, so goes the nation, but GM and the Autos are certainly a mighty force on the economy).

I include Ray*Signals' chart of the Auto group showing the group price, the relative strength of the group and the ratio of RS against itself today and six months ago. All three indices are bullish, so please don't short the Autos on the theory that Datsun is taking over the Western World! (Ray*Signals, 43 Lake Avenue, Montrose, PA 18801).

GOLD: Last week gold bullion (at 163) touched its primary bull trendline as shown on my semi-logrithmic chart. If gold continues to move sideways it will slip through the trendline, and I feel that this is almost sure to occur. What will it mean? What it will mean is that the growth rate, the inflation rate, the rate of increase which has held in force since 1971 is now breaking for gold bullion. If this break becomes decisive, we should then see bullion really come down in price (strange as this seems at this time). If so, we would probably see the final washout in the bear market for gold shares. At that point, the gold shares could become a most interesting buy again. In the meantime, it's patience, patience and more patience. Wall Street is more often than not a waiting game.

I talked about Homestake in the last report, indicating that HM was walking along a tenuous line. Last week HM broke below 43, and in so doing it slipped below a rising trendline which has held in force since September, 1974. The forces of higher costs vs. 164 dollar gold is slowly squeezing the gold stocks and their earnings. My calculations are that gold would have to rise 20% to 25% a year to hold share earnings even. A steady price of 160-170 for gold is going to mean lean-city for the shares. I have been writing that way ever since last year. I'm still saying it. Those who have listened are ahead of the game.

Next mailing: August 27.